

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 JEFF HATCH-MILLER  
CHAIRMAN  
3 WILLIAM A. MUNDELL  
COMMISSIONER  
4 MARC SPITZER  
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5 MIKE GLEASON  
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COMMISSIONER

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8 IN THE MATTER OF THE APPLICATION OF  
9 ARIZONA-AMERICAN WATER COMPANY,  
10 INC., AN ARIZONA CORPORATION, FOR A  
11 DETERMINATION OF THE CURRENT FAIR  
12 VALUE OF ITS UTILITY PLANT AND  
PROPERTY AND FOR INCREASES IN ITS  
RATES AND CHARGES BASED THEREON  
FOR UTILITY SERVICE BY ITS PARADISE  
VALLEY WATER DISTRICT.

Docket No. W-01303A-05-0405

13 IN THE MATTER OF THE APPLICATION OF  
14 ARIZONA-AMERICAN WATER COMPANY  
FOR APPROVAL OF AN AGREEMENT  
WITH THE PARADISE VALLEY COUNTRY  
CLUB.

Docket No. W-01303A-05-0910

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16 **RUCO'S REPLY BRIEF**

17 The Residential Utility Consumer Office ("RUCO") replies to Arizona American  
18 Water Company ("Arizona American" or "Company") and the Arizona Corporation Commission  
19 Staff's ("Staff") Post Hearing Brief as follows.

20  
21 **INTRODUCTION**

22 For the most part, on the issues that are in dispute, the Company and Staff are  
23 requesting special rate making treatment. RUCO's policy, to which it remains true in this case,  
24 is to recommend special rate making treatment only in situations that are extraordinary. For

1 example, in this case, RUCO does not oppose the proposed ACRM because RUCO  
2 acknowledges that the new federal arsenic standard presents a unique situation that  
3 necessitates special rate consideration.

4       However, where there is no reason to deviate from standard rate making principles and  
5 regulatory accounting practices, the Commission should not be persuaded by arguments that it  
6 do so. The standard rate making principles and regulatory accounting practices advocated by  
7 RUCO have been tested over time and strike a fair balance between the interests of  
8 ratepayers and the utilities. The fact that RUCO is advocating the Commission not stray from  
9 these principles and practices because the results are arguably not favorable to the public or  
10 have a harsh result does not make RUCO's position "extreme" or "wrong-headed." Company's  
11 Opening Brief ("Company's Brief") at 15, 42.

12       RUCO is charged with looking out for the interests of ratepayers. In doing so, RUCO is  
13 concerned with making well-reasoned, consistent recommendations that adhere to sound and  
14 tested regulatory principles. RUCO considers not only the effect of its recommendations on  
15 the Company and its ratepayers but also the precedential effect on future rate cases before  
16 this Commission. For each of its final recommendations, RUCO has consistently adhered to  
17 sound rate making principles and legal theories and in its Opening Brief ("Brief"), RUCO has  
18 presented its arguments in a straightforward manner. The same cannot be said for either the  
19 Company or Staff.

20       The Company, in its Opening Brief, has chosen to either willfully mischaracterize or  
21 wrongfully denigrate RUCO's position on most of the disputed issues. The Company attempts  
22 to create confusion by addressing non-issues and/or mischaracterizing RUCO's position in  
23 such a manner that it appears RUCO has "lost its way" or has forgotten whom it represents.  
24 Company Brief at 18, 38. The Company's bizarre statements are a non sequitur and the

Commission should not be persuaded by such transparent gimmickry. The Commission should make its Decision based on sound rate making principles and legal theories.

Staff, like the Company, has also chosen to deviate from generally accepted rate making principles. Staff's approach, however, is conciliatory. Staff has chosen to meet the Company at some mid-point on most of the issues that remain in dispute. While this approach may arguably appear equitable to the Company, it is not equitable to ratepayers and is not appropriate justification for deviating from generally accepted rate making principles. On the remaining issues in dispute Staff's reasons do not justify deviating from generally accepted rate making principles. The Commission should only consider recommendations that are supported by sound rate making principles and are consistent with the law in Arizona.

## **RECOVERY OF FIRE FLOW INVESTMENTS**

When a third party requests the construction of additional water infrastructure from a regulated utility it is the standard regulatory practice as well as a requirement of the Commission that the third party provide an Advance in Aid of Construction or a Contribution in Aid of Construction. Transcript at 159, R-11 at 8. Staff and the Company admit that this is the standard regulatory practice. Transcript at 159, 502 – 503. Here the Town, a third party, is requesting additional water infrastructure to meet its own imposed fire flow requirements and neither the Company nor Staff is recommending that the Town make a Contribution or Advance.

From the Company's perspective, the fact that the fire flow improvements will protect the lives and property of its customers and that its customers are supposedly willing to pay for the improvements causes the Company to wonder "*Whom does RUCO represent in this case?*" Company Brief at 38. The Company further hopes that RUCO will re-evaluate the

1 Company's view of the public interest and reconsider its position. Id. In support of its position,  
2 the Company only lists eight one sentence bullet points. In sum, the arguments in support of  
3 the Company's position as follows: a) the Town is asking for the improvements, b) the Town  
4 cannot fund the improvements and, c) the improvements would benefit its ratepayers. Id. at  
5 37-38.

6 With the exception of the faulty claim that the Town cannot legally fund the fire flow  
7 improvements,<sup>1</sup> RUCO does not take issue with the other two facts advanced by the Company  
8 in its Brief. However, as RUCO has clearly and consistently stated, the question at issue is not  
9 whether the Town needs the improvements, can fund the improvements or if the improvements  
10 are in the public interest, *but who should pay for the improvements*. Transcript at 411-412.  
11 Pursuant to generally accepted rate making principles, the Town, the third party requesting the  
12 improvements should fund the discretionary improvements it is requesting. The Commission  
13 should not embed municipal costs into basic public service rates and should not allow local  
14 elected officials to usurp its authority and obligation to set just and reasonable rates. Id.

15 The Company does not address the issue of who should pay other than to say the Town  
16 cannot legally fund these improvements. Because it purports to believe the Town cannot fund  
17 the improvements, the Company argues that ratepayers should fund the improvements.  
18 RUCO will not repeat the arguments it made in its Brief other than to highlight the following  
19 points. First, the Commission does not regulate fire flow standards. See Brief at 3. Second,  
20 the discretionary expenditures will not produce any additional revenue that weighs against  
21 including the improvements in rate base. Id. at 4. Finally, ***there is no legal impediment***  
22 ***preventing the Town from funding the discretionary improvements***. Id. at 5. The Town's  
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24 <sup>1</sup> RUCO has shown that the Town is not legally prohibited from funding the improvements. Brief at 5-9.

1 Fire Code does not require the Company to pay for the discretionary improvements and to  
2 interpret the Code to impose such an obligation on a public utility impinges on the  
3 Commission's exclusive Constitutional rate making authority. Brief 9-11.

4 Staff too evades the issue of which party should pay for discretionary improvements  
5 and, like the Company, relies on the public benefit argument to support its request to ratebase  
6 the discretionary improvements. Staff's Brief at 7. Staff also adds that its recommendation  
7 was based on its desire to encourage improvements in public fire safety and minimize deferral  
8 of costs pursuant to the Commission's accounting Order adopted in Decision No. 68303.  
9 Staff's Brief at 5. Finally, Staff has unquestioningly bought into the Town's claim that it was  
10 legally impeded from funding the improvements and suggests that the Commission should  
11 ratebase the improvements because the Commission may be the only alternative to bring the  
12 water system up to the Town's fire code standards. Id. at 8-9.

13 As discussed above, the public benefit is not the issue. Staff's notion of encouraging  
14 public fire safety through a rate case is completely misplaced. Again, the Commission has no  
15 Rule or policy setting fire flow standards. There is no statute or other law that suggests the  
16 Commission regulate fire flow. If the Commission feels compelled to set fire flow standards  
17 among the utilities it regulates, it should consider such an action in a separate Rule making  
18 Docket, not in a rate case. This type of ad-hoc policy making will potentially result in unfair and  
19 unreasonable rates.

20 Moreover, Staff's desire to minimize the deferral of costs is presumptuous. The  
21 Commission never made a determination as to what rate treatment it would afford the  
22 discretionary investment in Decision No. 68303. Minimizing deferral costs only has meaning if  
23 the Commission is going to approve ratebase treatment of those costs. The Commission has  
24 not made that determination and therefore minimizing the costs is not an appropriate reason

1 for deviating from the normal regulatory treatment of the discretionary costs at this time. The  
2 Commission should not ratebase the discretionary fire flow improvements.

3 Finally, Staff is simply wrong on the issue of the Town's legal ability to fund the  
4 improvements. But, for the sake of argument, even if Staff were right and the Town was  
5 legally impeded from funding the discretionary improvements, the fact that there may be no  
6 other funding source is not an appropriate reason for the Commission to ratebase the costs.  
7 Staff describes the case law on this issue of the Town's ability to fund the improvements as  
8 "large and complex." The reality is that the Supreme Court of Arizona addressed this issue  
9 squarely in *Town of Gila Bend v. Walled Lake Door Company*, 107 Ariz. 545, 490 P.2d 551  
10 (1971). RUCO demonstrated in its Brief that applying the Supreme Court's analysis in *Gila*  
11 *Bend* without question validates the Town's authority to fund the improvements. Brief at 5-9.  
12 Staff provides no legal analysis to support its sweeping conclusion and RUCO is not aware of  
13 any modification or changes to the *Gila Bend* case made by the Arizona Supreme Court, a  
14 Federal Court, or the legislature.

15 Staff, however, is satisfied to speculate that the Town's attorney considered the case  
16 law in his conclusion that the Town cannot fund the investment, and notes that as far as the  
17 record is concerned, there is nothing that would indicate that the Town could legally fund the  
18 investment. Staff's Brief at 8. Again, Staff is simply wrong. *Incredibly, it is the Town attorney*  
19 *himself, Andrew Miller, who in an exhibit introduced into evidence by the Company in this case*  
20 *told the Town's Water Committee that there is no legal impediment to the Town paying for the*  
21 *cost of fire flow infrastructure in the Town's other water utility, Berneil Water Company. A-31.*  
22 Mr. Miller's statement is consistent with what the Arizona Supreme Court said in the *City of*  
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1 *Gila Bend* case and is compelling evidence that the Town can legally fund the infrastructure<sup>2</sup>.  
2 The Commission should reject the Company and Staff's request to ratebase the discretionary  
3 fire flow improvements.  
4

## 5 **GAIN ON SALE OF LAND**

6 Typically, when there is a sharing of a gain on the sale of utility assets, the standard  
7 rate treatment is to adjust the Company's ratebase to reflect the ratepayers' share. In this  
8 manner, ratepayers are timely credited for their portion of the gain. The Company proposes a  
9 surcredit on each customer's monthly bill with no adjustment to ratebase. The Company  
10 computes the surcredit based on a five-year payout period, while Staff and RUCO propose a  
11 three-year amortization. Transcript at 334.

12 RUCO explained at the hearing that the only unresolved issue concerning the gain is  
13 the method of distribution of the gain to ratepayers. Transcript at 334, lines 7-8. The  
14 Company in its Brief addresses a non-issue – the payment of the capital gains tax associated  
15 with the sale. Company's Brief at 4-5. In fact, RUCO's concern is that a surcredit (whether  
16 computed on a five-year or a three-year amortization) allows the Company to get the benefit of  
17 the time value of money while the gain is being repaid through the surcredit. Transcript at 334.  
18 While a three-year payout of the gain shortens the period during which the Company would  
19 hold the ratepayer's funds, a three-year amortization still allows the Company to hold ratepayer  
20 money interest-free. It is therefore appropriate to reduce the ratebase to reflect the gain as a  
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24 <sup>2</sup> The only difference between the Berneil improvements and the Company's improvements is the magnitude of the cost, which is irrelevant to the issue of whether the Town can pay.

means to compensate customers for the time value of the Company holding their funds while it pays out the surcredit.

#### **RATE CASE EXPENSE**

The Company's recommended rate case expense, \$301,832 is excessive given the circumstances of this case. The bulk of the Company's request has to do with the Cost of Capital issue. The Company argues that it had no choice but to spend the large amount for the retention of the Brattle Group because "...the Commission has been using a flawed method to adjust returns on equity for differences in capital structure." Company's Brief at 7 at 8. The Company believes that its view of the cost of equity issue is a matter of first impression for the Commission. Id. The Company also advances the preposterous notion that its Cost of Capital arguments provide benefits only to ratepayers – not to its shareholders –which is why the Company is recommending the ratepayers pay the entire cost associated with the Company's efforts to correct the perceived flawed Commission practice. A-17 at 2.

All of the parties in this case are in agreement that the Company's capital structure is 63% debt and 37% equity. R-10 at 3. The parties also agree on the Company-proposed weighted cost of debt of 5.4%. Id. The main point of contention is the premium that each party allows for the risk associated with the Company's debt-heavy capital structure. Id. This point of contention is common in rate cases where a company has a debt-heavy capital structure. The only issue that is novel is the Company's proposal to address this risk premium. The fact that the Company's proposal results in the highest recommended Cost of Equity among the parties is unquestionable evidence that shareholders would benefit from the Company's argument if it were successful.



1 The Company has chosen to correct the Commission's "flawed" method by presenting  
2 financial theories that have only been accepted by one other public utility commission in the  
3 country. Transcript at 223. While RUCO is not suggesting that the Company should not be  
4 able to present its arguments, ratepayers should not have to bear the burden of paying even  
5 one penny towards the Company's novel, flawed, and anti-ratepayer approach.

6 The Company continues to describe the subject matter as complex and refers to the  
7 discovery efforts it made. Company's Brief at 9-10. RUCO does not deny that the Company  
8 engaged in discovery in this matter. But the issues that are contentious in this matter have  
9 become contentious because the Company has chosen to advance novel theories or practices  
10 that deviate from normal rate making standards and Commission practices and policies and  
11 that have been rejected elsewhere. Ratepayers should not have to pay and therefore  
12 encourage the Company to take novel positions that would result in increased and unjustified  
13 utility profits. The Commission should reject the Company's recommended rate case expense  
14 and accept RUCO's recommendation of \$73,179.

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16 **PENSION EXPENSE, NORMALIZE PAYROLL AND PAYROLL TAXES**

17 The Company has proposed an Arsenic Cost Recovery Mechanism ("ACRM"), which  
18 according to the Company is based solely on "actual costs and costs eligible for recovery,  
19 which are depreciation, gross return and recoverable O&M." A-19 at 15. The actual recovery  
20 of the ACRM costs will commence under the ACRM "after new arsenic facilities are in service  
21 and are in compliance with the new US EPA standard for arsenic." Now, prior even to the  
22 completion of the new arsenic facilities the Company is asking for special rate treatment to  
23 recover the labor costs associated with an arsenic plant operator it hired after the conclusion of  
24 the test year. The Commission should deny the Company's request to embed in the test year

operation and maintenance expenses the annual labor cost of an arsenic plant operator, of a plant that still is under construction.

It appears that the Company is making this request because of its realization that it will have to wait until the Company's next rate case in 2010 to request recovery for the operator's labor costs. Company Brief at 13. The Company, not RUCO or Staff, proposed the ACRM, which by itself is an exception to standard rate making procedure. RUCO, recognizing the unique circumstances that exist because of the new federal standard has agreed to the ACRM. A major reason why RUCO agrees with the ACRM is because the Company will recover its expenses after the facilities are in service and used and useful which is consistent with how the Company describes its ACRM. Id. In actuality, the Company is now asking for something different than what it proposed in its ACRM. The Commission should reject the Company's request to prematurely include the costs associated with the arsenic plant operator.

#### **ADMINISTRATIVE AND GENERAL ALLOCATED COSTS**

The Company's Brief addresses the following issues:

- 1) Annual Incentive Program ("AIP"), Company Brief at 15-16
- 2) Reorganization/Downsizing Expenses, Id. at 17
- 3) Ice, Id. at 17-18
- 4) Other, Id. at 18.

#### **AIP**

RUCO's recommendation is based on a sharing of the costs in proportion to benefits received by ratepayers and shareholders. RUCO is not proposing that the Company eliminate its Incentive Plan. Rather, RUCO's argument is to shift the cost burden onto shareholders for

1 that portion of the plan that benefits only shareholders, and not ratepayers. This is fair, and as  
2 the Company says – “There is little to add.”

### 3 **REORGANIZATION, DOWNSIZING AND NON-INCENTIVE PAY EXPENSES**

4 These expenses are non-recurring and atypical of test-year expenses. R-6 at 21. The  
5 standard rate making principle concerning these types of costs is to exclude them. The  
6 Commission should disallow the other reorganization, downsizing and non-incentive pay  
7 expenses.

### 8 **ICE**

9 Not surprisingly, the Company focuses on this issue to highlight what it considers the  
10 extreme positions that RUCO has taken in this case and to paint RUCO as an uncaring and  
11 insensitive agency<sup>3</sup>. Company Brief at 17 – 18. The Company goes as far as saying that  
12 “RUCO appears to have lost its way.” All the while, the Company fails to address the issue in  
13 question.

14 The issue here, as with the fire flow improvements, concerns the rate treatment of the  
15 Company’s discretionary expenses. The standard rate treatment regarding discretionary  
16 expenses is to not include them in rate consideration. The issue has nothing to do with  
17 RUCO’s sensitivity to the needs of the Company’s workers, and the fact that “ice is needed to  
18 protect employees from possible death in the Arizona sun.” Company’s Brief at 18. If that  
19 were the case, the Commission would also have to consider the employee’s food and shelter  
20 expenses, as they are also necessary to protect employees from “possible death in the  
21 Arizona sun.” The Commission should consider only those expenses necessary to provide  
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24 <sup>3</sup> According to the Company it takes a “hard heart to lump ice for field-workers in the same category as smoothies and donuts.”

1 water service to the Company's ratepayers. The Commission should reject the inclusion of  
2 discretionary expenses like ice.

### 3 **OTHER EXPENSES**

4 The Company is critical of RUCO's position as being "extreme", yet in the same breath  
5 the Company believes ratepayers should pay for indoor plants that "beautify the workplace,  
6 take in carbon dioxide and expel oxygen." Company's Brief at 18. This position proves  
7 RUCO's point that once the Commission allows discretionary expenses every cost imaginable  
8 becomes fair game. This is exactly why it is so important that the Commission adhere to  
9 generally accepted rate making principles.

### 11 **PROPERTY TAXES**

#### 12 **PROPERTY TAXES ASSOCIATED WITH THE MTRF**

13 Motorola has refused to pay the property taxes for the MTRF and the Company has not  
14 pursued the matter. As a result the Company's test year expenses include an amount for  
15 these taxes. The Company argues that it accounted for the property tax associated with the  
16 MTRF through its property tax calculation, which utilized the methodology approved by the  
17 Commission in the past. A-15 at 38.

18 The issue, of course, has nothing to do with which interpretation of ADOR's property tax  
19 formula is appropriate. The issue concerns whether or not the actual property taxes  
20 attributable to the MTRF during the test year should be considered as part of MTRF's  
21 operating expenses and therefore reimbursed by Motorola. The Company, by claiming the  
22 property taxes are not part of the MTRF's operating expenses during the test year, overstates  
23 its property tax expense by \$42,000.

1 Without exception, property taxes are part of the cost of operating a business. Here,  
2 MTRF's actual property taxes are known for the test year. Since the Company owns the  
3 MTRF, the actual property taxes of the MTRF should be included as part of MTRF's operating  
4 expenses and reimbursed by Motorola. The generally accepted regulatory practice is to  
5 include property taxes as part of a Company's operating expense. The Company's  
6 interpretation of its unresolved contractual dispute regarding the classification of the property  
7 taxes should not exclude the actual property tax expense from rate consideration. The dispute  
8 needs to be determined outside of this rate case under the remedies provided in the contracts.  
9 In the meantime, the Commission should reject the Company's determination that the MTRF's  
10 actual property tax expense should be included in rates.

#### 11 **PROPERTY TAXES BASED ON THE ADOR FORMULA**

12 The Company states that ADOR methodology understates its property taxes and has  
13 been repeatedly rejected by the Commission. Company Brief at 14. It is true that the  
14 Commission has rejected the ADOR methodology. Nonetheless, RUCO has repeatedly shown  
15 that the ADOR methodology is the most accurate estimate of the Company's property tax. In  
16 this case, as in others where the actual tax figures for the test year are known, the ADOR  
17 formula is consistently more accurate than the Company's methodology. Here, using the  
18 Company's as well as Staff's methodology, property taxes for 2005 would have been  
19 overstated by \$51,048 which would have allowed the Company to over earn for several years  
20 until that level of tax was actually assessed. R-5 at 23. The Commission should reject the  
21 Company's and Staff's recommended property tax calculation and accept RUCO's  
22 recommended property expense of \$170,334. RUCO Post Hearing Schedule RLM-3, page 4.

## **WORKING CAPITAL, INCOME TAX EXPENSE, RATE DESIGN**

Neither the Company nor Staff has presented any arguments in their Briefs supporting their recommendation that cash working capital should be \$0. Company Brief at 4, Staff Brief. RUCO stands by its arguments in support of its working capital recommendation as more fully set forth in its Brief at pages 23 – 25.

RUCO also has nothing further to add to the arguments it made regarding income tax expense and rate design as set forth in its Brief at pages 27-29.

## **PLANT HELD FOR FUTURE USE (“PHFFU”)**

The Company and Staff both discuss the Company’s use of the backup equipment for Well No. 16 in their Briefs. Company Brief at 5 - 6, Staff Brief at 10 – 11. This is no longer an issue as RUCO has agreed that the back-up equipment at issue is used and useful and has agreed to include it in ratebase. Transcript at 368-369, RUCO Brief at 28. RUCO’s final ratebase recommendation includes the costs associated with the back-up equipment.

## **COST OF CAPITAL**

RUCO continues to urge the Commission to adopt RUCO’s recommended 10.00 percent return on common equity for Paradise Valley. The Company proposes to adjust for its debt-heavy capital structure by employing a generally non-accepted financial theory called Equitable Leverage Compensation. Company Brief at 28. The Company equates Equitable Leverage Compensation to the Commission’s use of a hypothetical capital structure in situations where a company is highly leveraged. Id. The result of applying the Company’s novel financial theory is 12% cost of equity recommendation, which clearly overcompensates for the Company’s financial risk.

1 RUCO, as well as Staff, addressed the higher debt ratio by determining what would be a  
2 fair amount of basis points to add to the results of its DCF and CAPM analysis. This is the  
3 generally accepted way the regulatory industry accounts for financial risk. In this case, RUCO  
4 considered the adjustment the Commission authorized in the Company's most recent case to  
5 arrive at its recommendation. The Commission should adopt RUCO's recommended Cost of  
6 Capital.

## 8 **CONCLUSION**

9 RUCO recommends the Commission reject the Company's proposal to ratebase  
10 discretionary fire flow projects. RUCO recommends that the Company's rate base be offset by  
11 the ratepayer's portion of the gain on the sale of the plant located on Casa Blanca Drive.  
12 RUCO recommends that the annual distribution of the gain be recorded on the income  
13 statement as a credit to operating expense. Further, RUCO recommends the Commission  
14 adopt its remaining recommendations to the following:

- 15 1) Rate case expense - \$73,179;
- 16 2) Pension Expense, Normalized Payroll and Normalized Payroll Expense – Reject  
17 the Company's request to include expenses associated with arsenic recovery  
18 which include the following;
  - 19 1) Payroll –(\$41,603)
  - 20 2) Payroll Tax –(\$4,295)
  - 21 3) Pension expense –(\$2,205)
- 22 3) Administration and General Allocated Expenses –
  - 23 1) AIP-\$12,795
  - 24 2) Reorganization/Downsizing and non-incentive pay - \$42,441





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